STATE OF CONNECTICUT
TEACHERS' RETIREMENT BOARD
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UNDERSTANDING THE FUNDING OF THE TEACHERS' RETIREMENT SYSTEM

When did the Connecticut Teachers' Retirement System implement an actuarial funding program?
The Legislature established an actuarial funding program in 1979 (Public Act 79-436).

How was the system funded prior to 1979?
Prior to 1979, the Retirement System was funded on a terminal basis. Using actuarial tables, CTRB determined the amount that would be required to fund the retired member's pension benefit (Pension Reserve) when the member actually retired from service. This amount was then appropriated by the Legislature and deposited in the Retirement Fund to pay the benefits over the member's lifetime. Any cost of living adjustments that were paid were funded on an annual cash basis from General Fund Appropriations.

What is actuarial funding?
Actuarial funding is a systematic program of funding pension costs during the period of time that the benefits are earned as well as a method for amortizing unfunded past service liabilities over a defined period of time.

How is this usually done?
The value of the benefits earned during a particular year is typically referred to as "normal cost". In most cases, the plan's actuary determines the percentage of the total payroll that must be appropriated to fund the value of the benefits earned during a plan year.

What is a past service liability?
A past service liability is a benefit that was earned during a prior plan year(s) that was not fully funded or that portion of normal cost that was not fully paid during a plan year. The unfunded past service liability is amortized over a period of time. For the CTRB plan, this amortization is calculated based on a level percentage of payroll. Any amendments to the plan affecting the past service liability are to be amortized over a period of thirty years.

What's the advantage of actuarial funding as opposed to terminal funding?
Putting aside money each year as the person renders service allows a plan to take advantage of the investment income that would be earned during the person's working career. The effect of compound interest over time helps reduce the cost to the plan.

For example, let's say that you will need a total of $10,000 ten years from now. If you put aside $690 each year for ten years and assuming an 8% interest per year, over a period of ten years you would have accumulated $10,000 ($6,900 principal + $3,100 interest).

When the Legislature established the actuarial funding program in 1979 (Public Act 79-436) what was the funding schedule?
The Legislature gradually phased in the funding schedule. For the first year, the funding was 35% of the normal cost and forty-year amortization of past service liabilities and increased by 5% for each succeeding year eventually reaching a funding level of 100% of the normal cost and amortization of past service liabilities. Beginning in 1992 the law required that the system be funded at 100% of the normal cost and full forty-year amortization of the unfunded past service liabilities.

Has the Legislature adhered to the funding schedule?
No. Despite the fact that the law requires funding to be at 100% of the normal cost and forty-year amortization of the unfunded liability, with the exception of fiscal year 2001-02, the Legislature has frozen the funding at 85% of the level required since 1992. Since the inception of this funding program, there have been numerous "technical changes" and budgetary cutbacks that have impacted the funding level.

What is the Retirement System's unfunded liability?
According to the most recent actuarial valuation of the fund as of June 30, 2002, the System had an unfunded liability of approximately $3.3 billion dollars.

How has the underfunding affected this liability?
From 1990 through 2002, this underfunding has added an additional $987 million dollars to the system's unfunded liability.

What does it mean when they say a plan is "fully funded"?
We have to be very careful when we use the term "fully funded". Generally this means that a plan has sufficient assets in the fund to pay all of the accrued benefits earned as of a specified date. In CTRB's case, as of June 30, 2002, we had sufficient assets on hand to fully fund approximately 78% of the benefits earned as of that date.

On the other hand, the CTRB plan is not receiving the "full required annual contributions" according to the funding schedule required by the law. The continual shortfall in required contributions will continue to increase the unfunded liability of the fund. This cost will ultimately be passed on to future taxpayers and will require even greater contributions in future years to meet these obligations.

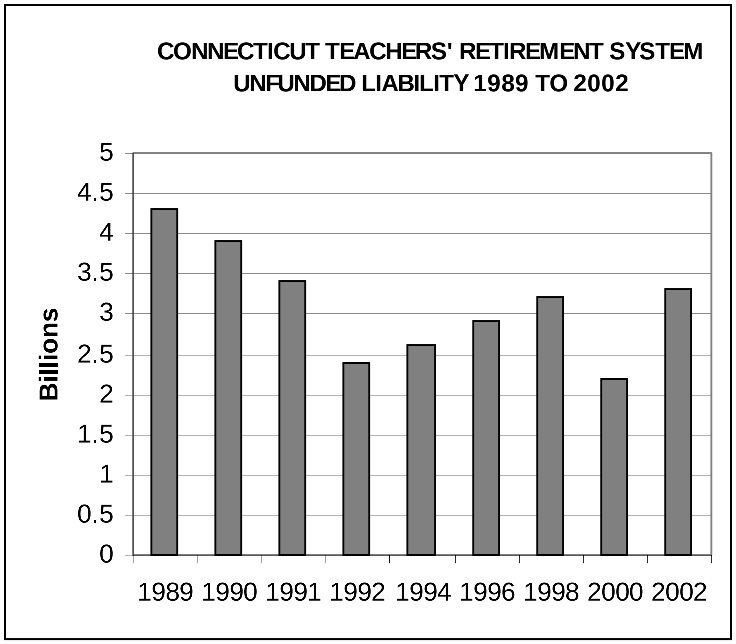
During the mid nineties, the average annual rate of return for the Retirement Fund was almost 15%. Unfortunately, the opportunity to have these funds available for investment during a period of outstanding rates of return has been irretrievably lost.

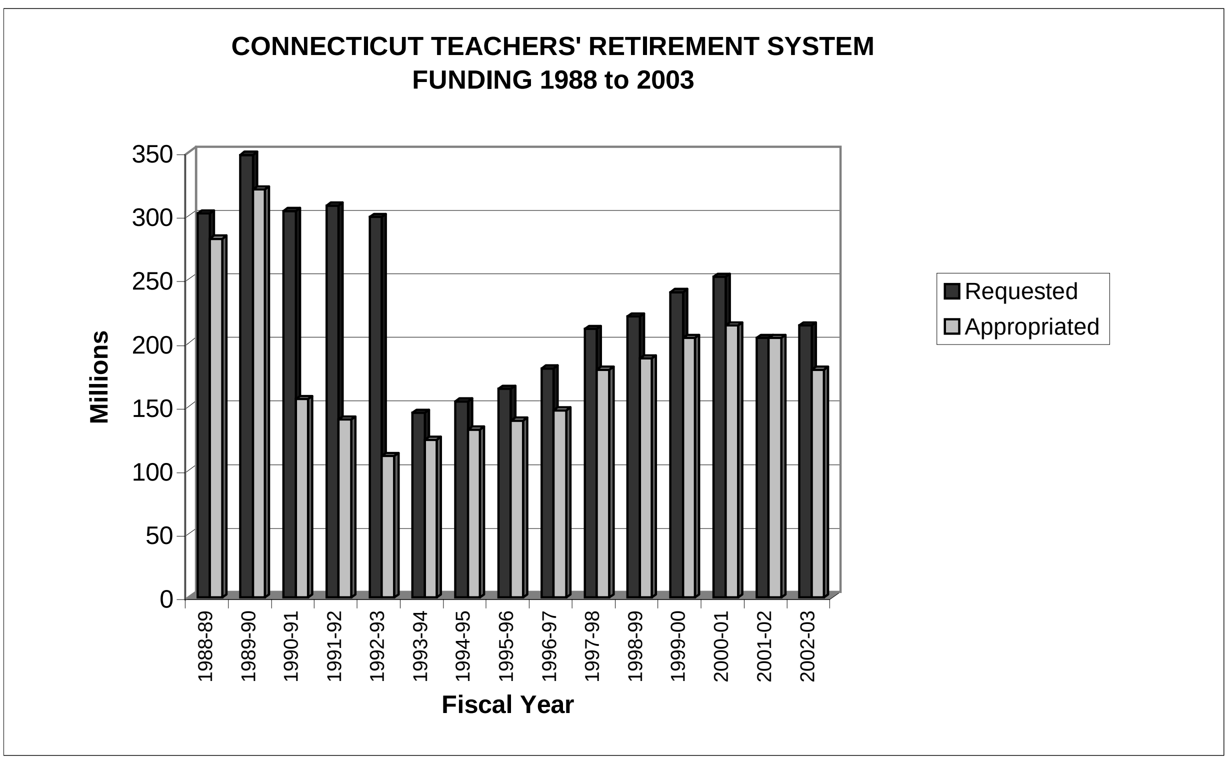
It should be emphasized that the payment of the "full required annual contributions" is an integral part of the long-term goal of paying off the unfunded liabilities of the system over a period of years and ultimately achieving a "fully funded" plan.

Does this underfunding affect the ability of the system to pay benefits?
No. At the present time there are adequate assets to continue to pay benefits. As of June 30, 2002, the Market Value of the Retirement Fund was approximately $10.1 billion and the annual payroll for benefits was approximately $755 million. In the event there were to be a shortfall, the State would be obligated to appropriate funds to pay legally obligated benefits. It should be noted that the Retirement Fund has been experiencing remarkable rates of investment return over the past five years and that the investment income coupled with annual employee contributions and state appropriations has not required the use of the fund's assets to meet these obligations. However, as benefit payment costs increase and the rates of investment decline, it is conceivable that fund assets may have to be liquidated to meet these costs.

What is the reason for the underfunding of the system when we have been having budget surpluses each year?
Apparently, the Legislature has placed higher priorities on other programs despite the legal requirements to fund the program. Although a constitutional-spending cap is often cited as the reason for freezing the funding level, there has not been any effort to apply the surpluses toward the system's unfunded liabilities or to phase in the funding to the required 100% annual funding level.

What can be done?
The Legislature, as well as key policy makers, must be made aware of the serious ramifications that will result if the system is not properly funded. Annual benefit payments now exceed the amount of revenue received from active teachers and from state appropriations thus requiring the system to use investment income to meet these financial obligations. The State has enjoyed strong economic growth and prosperity over the years but still has failed to meet its commitment to properly fund the system. The situation could be exacerbated should the economic climate enter a prolonged economic downturn.





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